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» Fisch View

August's topic: „Reality versus expectations"

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Reality versus expectations

– The consumption-based US economy is proving robust, while manufacturing-intensive economies are showing weakness.
– A "soft landing" combined with key interest rates retrenching imminently are contradictory forces but are nevertheless being priced in, which may lead to negative surprises.
– We remain cautiously positioned in our strategies with equity and high yield exposure, while downgrading our investment grade bond positioning to neutral due to the further tightening of credit spreads last month.

Overall economic situation

The cycle of extremely restrictive monetary policy is now starting to have a discernible impact on the economy and inflation. This is due to the usual lag of at least 12 months. So far, we are seeing a slowdown primarily in manufacturing, but not (yet) in consumption and labour markets.

Recent developments: The US economy stands out

— Global equity markets continued to rise in July, fuelled by hopes of a “soft landing” of the economy and thus the avoidance of a recession. This was also reflected in the increased market breadth and the relatively better performance of cyclical stocks. The persistently narrow spreads for investment-grade and high-yield bonds in the US fit into this picture.
— Both the Fed and the ECB raised their key interest rates by a further 0.25% at the end of July, as expected. Due to the lower but still too high inflation rates, they are sticking to their data-dependent approach and did not give any concrete expectations for the future path of interest rates. The Bank of Japan announced that it would make its ultra-loose monetary policy more flexible in order to prevent a further weakening of the yen and to take account of the rise in inflation.
— Globally, there is a clear divergence between the robust services sectors and the weakening manufacturing sector. As a result, the consumption-based US economy is resilient, while the signs of weakness from manufacturing-intensive economies, such as China and Germany, are increasing. In the eurozone, the restrictive monetary policy is already having an impact, as evidenced by declining commercial bank lending and consumer confidence. China’s economic recovery has disappointed thus far, and the country is struggling with the threat of deflation, prompting the government to announce various stimulative measures.

➲ **On the radar:** Can the US economy continue to surprise? (page 6)

Overview & outlook: A “Soft landing” and declining rates – a contradiction?

» Easing monetary policy too early could have serious consequences

— The positive performance of equity markets and the low volatility on both sides of the Atlantic reflect the investors' increased risk appetite and are based on two potentially contradictive assumptions: on the one hand, a “soft landing” of the economy and, on the other, a lowering of interest rates soon due to falling inflation. While there are valid arguments for both assumptions separately, a simultaneous occurrence of both scenarios and a transition to a “Goldilocks scenario” is extremely unlikely.

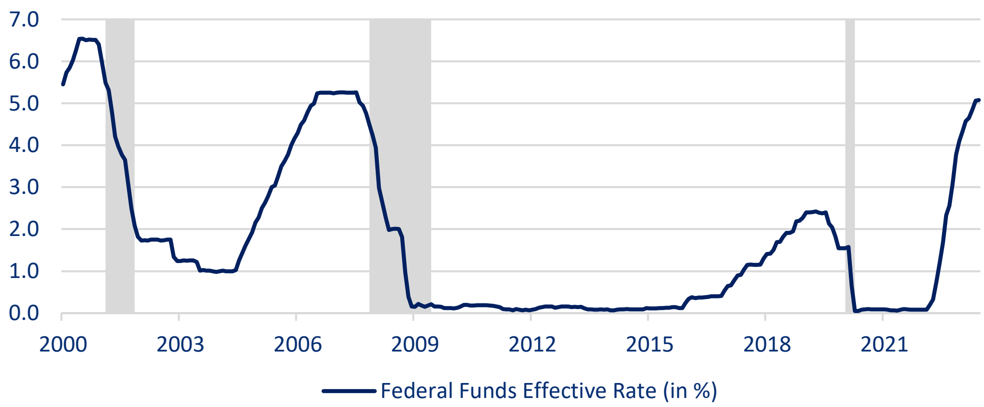
— In the event of a soft landing of the economy, we expect inflation to stagnate at best. It could also rise again, in which case, interest rates are likely to be raised further. Central banks, based on their mandates, can only begin to ease interest rates again once inflation has fallen sustainably and the inflation target of 2% has been reached. Experience from the 1970s shows that easing too early can lead to even stronger inflation dynamics, which in turn would have to be fought with even more drastic interest rate hikes.

— The Bank for International Settlements (BIS) writes of the “challenge of the last mile” towards the long-term inflation target of 2%. The continuing high core inflation rates, which are due to the tight labour market and rising prices for services, complicate the global disinflation process, and can only fall sustainably as a result of a decline in aggregate demand, as well as higher unemployment rates, which, however, is difficult to reconcile with a soft landing.

— In this respect, we continue to see a difficult starting position and negative surprise potential for equity and high-yield markets, as either the economic environment will deteriorate faster than expected or key interest rates will remain higher for longer than expected.

— Economic history shows that plateaus at the end of a rate hike cycle are the rule, not the exception. The Fed cuts rates when a recession is imminent and it wants to support the economy, not when the end of a period of fighting inflation is in sight (see chart).

Chart: Interest rate easing is guided by the economy, not inflation



Note: The shaded areas reflect periods of recession in the US
Source Federal Reserve Bank of St. Louis, Fisch Asset Management

Positioning: Remain cautious on equities and high yield – Neutral view on investment grade bonds

» We are optimistic for emerging markets due to the room for manoeuvre of central banks.

— In our strategies with equity and high-yield exposure, we continue to position ourselves defensively compared to the previous month due to the clouded economic outlook, while we are building up exposure to selected US growth names due to the resilience of the US economy so far.

— In Japan and the emerging markets, we are more positive about the overall growth outlook. Japan continues to have an extremely loose monetary policy with a positive impact on equities, despite the unpredictable flexibility inherent in its yield curve control. The emerging markets are already further advanced in the monetary tightening cycle and an economic slowdown could be countered with interest rate cuts by the central banks - as we are already seeing in Latin America. We therefore continue to position ourselves neutrally and take advantage of interesting opportunities in corporate bonds.

— In investment grade corporate bonds, we have downgraded our positioning to neutral after credit spreads tightened further last month. At current levels, we see limited upside potential from further credit spread tightening and little downside protection given the tight monetary policy environment. Overall, however, the market continues to offer attractive interest rate carry, leading to a positive total return expectation.

— For long-term government bonds, we continue to see both positive (falling inflation, economic slowdown) and negative factors (high Treasury issuance volumes, potential for further interest rate hikes). We remain neutral on government bonds and duration, although negative factors may temporarily prevail.

— As the central bank rate hike cycle is now likely to be well advanced, we are now neutral on precious metals. The global economic slowdown is likely to continue to have a negative impact on industrial metals, while we have a neutral view on energy due to additional supply cuts.

	US	Europe	Japan	Asia ex-Japan	LatAm	CEEMEA
Equities	-	-	+	o	o	o
Government Bonds	o	o	o			
Credit IG	o ↓	o ↓		o	o	o
Credit HY	-	-		o	o	o
Convertibles	o ↑	-	o	o		

	PrecMet	InduMet	Energy
Commodities	o ↑	-	o ↑

Key:

++	Strong positive
+	Positive
o	Neutral
-	Negative
--	Strong negative

Notes regarding the table: Changes from prior month are indicated with ↓ or ↑. i.e. "O ↓" means that the output has weakened from a prior value of + or ++. The methodology for calculating model outputs, and how the various pieces fit together to form the big picture, is explained here.
Within government bonds, we consider the most important bonds for each region, e.g. German Bunds in Europe, and a representative group of countries for Latin America, Asia ex-Japan and CEEMEA (Central and Eastern Europe, Middle East and Africa).

Cross asset class preferences

This table combines top-down views with bottom-up analysis at the portfolio level.

	Most preferred	Least preferred
Convertible Bonds	– CBs with positive yield – Stocks with strong secular trends (renewables, healthcare) – Selected growth names	– Weak credit quality and/or liquidity – REITS
Global IG Corporates	– Energy, healthcare – 5-10 year maturities	– Real estate – Maturities >10 years
Global Corporates	– Energy, healthcare – Investment grade – Developed markets	– Real estate, transport – High yield – Emerging markets
Global High Yield	– Telecoms, energy – Basic industry	– Retail – Technology – 'CCC' rating segment
Emerging Markets - Defensive	– Middle East – Indonesia, South Korea – Maturities <10 years	– LatAm, Taiwan, Brazil, Hong Kong – Maturities >10 years
Emerging Markets - Dynamic / Opportunistic	– High yield energy, gold miners – LatAm (esp. Mexico and Colombia), Indonesia	– Deeper credit B/CCC segment

Note: Preferred sectors/regions may differ between asset classes owing to respective performance drivers. In particular, equity exposure is the key performance driver for convertible bonds and is not relevant for corporate bonds.

On the radar: Can the US economy continue to surprise?

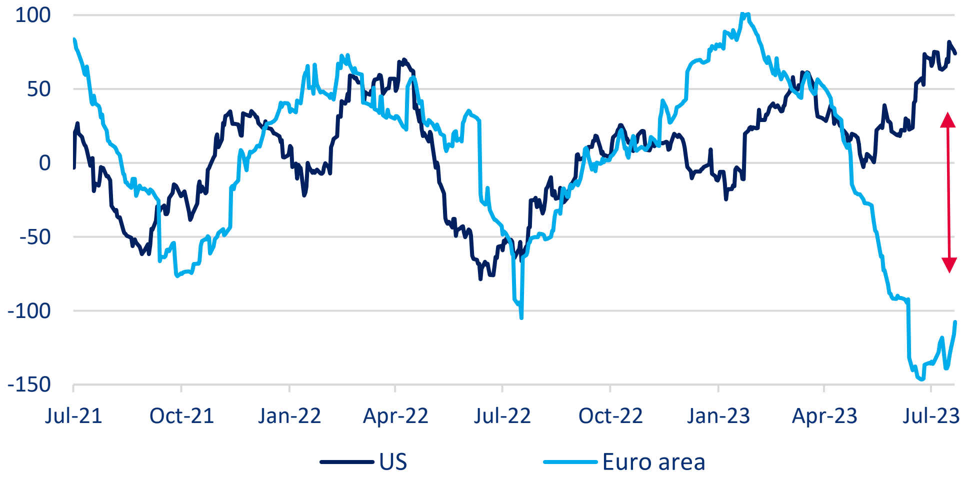
The Citi Economic Surprise Index measures the extent of positive and negative surprises of published economic figures in relation to market expectations for various economic areas. As can be seen in the following chart, the index for the US rose sharply relative to the euro area in recent months. While the US index climbed to its highest level since the beginning of 2021, the readings for the euro area have only been lower twice since measurements began in the early 2000s - during the global financial crisis and at the start of the Covid pandemic.

» Europe is facing major challenges

In the US, economic growth in the second quarter of this year, the acceleration of real private consumer spending and the decline in inflation, among other things, turned out better than expected. On the other side of the Atlantic, however, various economic figures disappointed. In particular, leading indicators such as the weak purchasing managers' indices and declining consumer confidence point to a difficult starting position for the rest of the year.

So, while the restrictive effect of monetary policy in the euro area cannot be overlooked, robust consumption in the US is keeping the US economy afloat - high interest rates have not yet fully hit consumers. This is because much of household debt is still tied to lower, fixed interest rates. According to Moody's, only about 11% of household debt is linked to floating rates in the first quarter of this year, and thus affected by higher policy rates. On the corporate side, however, bank lending standards have tightened further, and restrictive monetary policy is increasingly coming into play. It would be historically unique if the US economy could decouple from the restrictive credit cycle and thus avoid a recession and continue to surprise on the upside.

Chart: Citi Economic Surprise Index – a gap has started to emerge



Source Citi, Bloomberg, Fisch Asset Management

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